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Distribution pricing limbo: How low can you go?

by Scott Benfield

In the recent economic recovery, industrial distributors received needed pricing relief in two distinct ways. First, capital spending, which was in the doldrums, rebounded nicely in the last year. Secondly, worldwide demand for basic commodities outstripped supply, and prices rose several times in the past 18 months or so. Compared to the recent past, as markets expanded and money became available to spend, the ability of distributors to get pricing increases has never been better.

Before you become too optimistic, however, some troubling signs on the horizon may dampen your euphoria. First, capacity for commodity production is improving in countries like China and Eastern Europe, which are gearing up to solve their commodity needs for steel and basic raw materials. As world supply increases, prices will fall. Secondly, the general consensus among executives is that pricing competition will heat up in 2005¹ and the domestic GDP growth will fall short of last year's pace by a considerable amount.

The result for distributors serving business-to-business markets is that the growth of the last 18 months is cooling off. Among other things, distributors will need to manage costs more closely and prices will begin to fall. Many distributors are confused over a basic aspect of the pricing discipline, namely how low can you go in price before you can't cover your costs? The answer is not as simple as it seems. This article explains how to win the pricing limbo contest without dragging profits into the dirt.

When to play pricing limbo

Most distributor pricing should not be part of the limbo contest. Regular, small orders of a variety of off-the-shelf products are the stock-in-trade of distribution. These should be priced using a properly designed pricing system that includes the marketing variables of customer size, segment, product velocity and geographic competition. We call this System Pricing² and there is no substitute for using the I/T system's pricing module for capturing pricing differentiators of customer type, size, etc., and integrating this in a matrix logic with manufacturer costs and list prices. The resulting pricing system will yield higher margins for stock orders vs. the cost-plus pricing that still, to our chagrin, dominates distributor pricing practices.

A proper System Pricing logic takes tremendous work in customer classification, product classification, system design and maintenance. We don't recommend the exercise unless there is a strong commitment to the cause. But, we also don't know how to maximize profits and properly capture value without System Pricing (unless, of course, you want to



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be a part of the trend of falling distributor net worth in industrial markets³).

However, there are buying situations where cost-plus pricing is permissible and necessary. This is the playing field for limbo. Cost-plus pricing comes into play where there are exceptions to the small stock order.

These situations include:

- Integrated supply or vendor-managed agreements where the sales volume is high and put out for competitive bid.
- Job bids found in construction or capital spending markets where a large dollar-value construction project or capital expansion is planned.
- New product development projects for OEMs that involve continuous need, in large volumes, of a part or process piece integral to the finished product.
- Large orders of non-stock products needed for special-use situations.

These buying situations are common grounds for cost-plus pricing and the game of pricing limbo. Typically, most distributors don't play limbo so well. Their estimation of issuing lower margins to secure the order are far in excess of their costs of serving the order. Their profits suffer as a result.

What Limbo is, what it is not, who sets the rules for it, and who should play it

We've described where pricing limbo can and should be played; now we need to define Limbo and its components. The game of Limbo is about setting the absolute lowest price to secure the order and still making an acceptable return. It involves estimating the costs to serve the order, beyond the product costs, and setting a **cost floor**.

Limbo pricing is not related to the common sales negotiation and "defining value for the customer" pricing taught to leagues of sellers. It is also not directly related to the popular "customer profitability" concept, although activity costing used in customer profitability seminars can help.⁴ These tools offer relief in the dropping profit environment of distribution but they won't counter the fundamental trend of prices being driven to the marginal cost to serve.⁵

Executive managers and sales managers should set the limbo rules and make sure salespeople play the game within the rules. Those who don't play by the rules, evidenced by repeated selling under the cost floor, should be sidelined or traded to another team.

To set the cost floor, distributor managers and execs need a basic understanding of the three types of cost classifications, which are:

- Costs that vary directly with volume, which are costs of goods sold.
- Costs that are more or less fixed, which include branch rent or overhead, executive salaries, capital equipment including delivery vehicles, machinery, I/T expense for hardware and software and any other expense that varies little with sales volume.
- Costs that step up with volume, including outside sales,

inside sales, accounting work of receivables and payables, pulling, packing and shipping orders, and support expenses of phone, postage and purchasing. In general, any cost related to the day-to-day operations of ordering products, taking the customer request, and moving products from the warehouse to the customer are step costs.

The key in setting a cost floor is to understand, at a minimum, which costs need to be covered in the price. Since cost-of-goods are a known entity, they must be covered in the price. In a sense, however, they are a non-sequitur, since it's safe to assume material costs are competitive, otherwise the firm would not be successful in a commodity environment. Fixed costs need to be covered in the long run, but they don't step up with volume. The strategic goal for fixed costs is to generate enough margin dollars to **contribute** to them. Step costs, however, are the ongoing cost to serve incoming orders. In essence, each new order causes the cost of inside sales, outside sales, warehouse labor, purchasing labor, accounting and shipping to rise. Some step costs closely follow volume including shipping, warehouse labor and inside sales. Other step costs gradually rise with volume including outside sales, purchasing and accounting.

In essence, categorizing step costs is the beginning for calculating the cost floor. Step costs are service costs related to the order. Step costs must be covered to give the firm the capacity to process more orders with a reasonable level of service quality.

To calculate a firm's ongoing step costs, we'll use mock distributor DuPage Industrial Supplies of West Chicago, Ill. DuPage management has a chance to sell 50,000 spiraled widgets a year to local manufacturer Naperville Sweeper for a new line of street sweepers. The cost of goods for each spiraled widget is \$10, with an expected yearly material cost of \$500,000. DuPage Industrial purchasing management solicited competitive bids on the spiraled widget, and the \$10 per-widget price was the most competitive, plus was guaranteed for 18 months. In the previous year, DuPage Industrial had a 20 percent margin on sales and a 17.5 percent cost of operations, which left a 2.5 percent operating margin as a percent of sales. Naperville Sweeper is a large company with a good credit history and good purchasing practices. Its material costs for the new sweeper are competitively shopped and it receives sealed bids from various suppliers, awarding the quote to the low-cost bidder.

DuPage Industrial's CFO, Mike Mooreland, sets the cost floor for the Naperville Sweeper bid. First, he outlines the step costs integral toward servicing the business. He gets an estimate of these costs as a percent of sales by averaging year-end ledger costs.

The categories and their associated costs as a percent of sales are as follows:

- Outside sales, salaries, benefits, bonuses and travel = 4% of sales.
- Inside sales, salaries, benefits, bonuses, etc. = 3% of sales.
- Warehouse operations of receiving, pulling and packing

=1.5% of sales.

- Shipping, including driver, vehicle maintenance and fuel = 2% of sales.
- I/T time dedicated to the account estimated at .5% of sales.
- Accounting time dedicated to the account estimated at 1% of sales.
- Purchasing time dedicated to the account estimated at 1% of sales.
- Phone and misc. support for the account estimated at .25% of sales.

The total cost of service (step costs) for the Naperville Sweeper bid is 13.25 percent of sales. The minimum profit return on investment for DuPage Industrial is a 15 percent margin, which means the cost-plus factor on product is a 13.25 percent cost-to-serve divided by a factor of .85 to yield 15.6 percent. So, if the yearly material costs are \$500,000, the minimum price for the bid is \$592,417. This will cover the step costs to serve and ensure an adequate return-on-service investment. So, Mike Mooreland sets a minimum floor for the bid and works with sales to check the accuracy of the costs specific to the customer.

Limbo caveats and limbo losers

Estimating step costs and applying a minimum return is a simple way to set cost floors. Using year ending ledger costs, as a percent of sales, is a reasonable way to estimate step costs that are ongoing parts of the service platform. However, distributors should be careful to acknowledge that traditional costs may be high, the customer may not need all the services that are traditionally provided, or there may be lower costs substitute services. For example, if DuPage Industrial's warehouse operations are inefficient and shipping costs are high, a competitor with more efficient operations can offer a lower price. Secondly, Naperville Sweeper may be content with placing orders online vs. needing full sales assistance. In our research, the cost of an e-commerce offering as a percent of sales is less than 1 percent vs. the DuPage Industrial cost of an inside and outside sales force at 7 percent of sales. The difference is 6 percent of sales, a substantial cost decrease (more than \$30,000) for Naperville Sweeper should they choose to place orders online. And, finally, Naperville Sweeper may elect to pick up the materials, saving freight charges, or have the materials shipped direct, which will change the cost picture and their resultant price. In setting cost floors for large, contested orders, distributors should be careful to understand the discreet costs of service and how they might be able to offer lower-cost services or provide fewer services for a better price.

Given the accepted use of activity costing for modeling customer orders, many distributors attempt to use activity costs to approximate the cost to serve a customer for a contested sale. One of the more serious errors made in activity costing is dividing fixed costs of branch overhead and executive salaries over volume. In essence, approximately 30 percent to 40 percent of a distributor's costs are more or less fixed. If these costs are divided over volume, the cost-per-order appears to go up. The math of dividing fixed costs over volume makes the cost appear variable but it is not. Therefore, we highly recommend

leaving fixed costs out of activity calculations as they typically lead to erroneous analyses.

When estimating step costs, be sure to include liberal estimates of the ongoing costs to serve and understand the cost of capital. We recently found a distributor that accepted a \$5 million order for a 5 percent cost-plus margin. The company rationalized the margin by reviewing the cost-per-order and, since average orders were large, believed the margin dollars generated by the order would cover all the processing costs. When we reviewed the analysis, we found it did not include cost of outside sales and estimates for I/T and purchasing. It only included the more directly attributable costs of inside sales, warehousing and shipping. Secondly, the firm had no concept of its weighted average cost of capital. We ran the numbers and found out capital costs were 8 percent, and the company priced the order for a return 3 percent lower than its capital costs. In short, based on our analyses, the order was a loser and destroyed the firm's value. This is not a unique situation; faulty cost analyses or sales-driven analyses in pricing large "bid" orders often lead to losing situations.

Limbo analyses

Mike Mooreland, in practicing for Limbo, used the cost floor to check DuPage Industrial's account base for those below the cost floor. He simply took the assigned account base and ranked them by margin percent from high to low. When he found accounts that yielded a gross margin percent less than 15.6 percent, he flagged those as being below the cost floor and took corrective action.

In our pricing audits, we regularly review cost floors and, on average, find 20 to 25 percent of the accounts below the cost floor. It is not practical to have all accounts above the cost floor, however, a quarter of the accounts below the cost floor only damages profits in a sector where profits and productivity are at historic lows.

Pricing limbo is a game with profit consequences that should be played within rules set by executive management. Salespeople setting their own limbo limits too often set prices lower than ongoing step costs. The result is the salesperson gets paid on extra margin dollars but the firm's cost to service the order is higher than the generated margin dollars.

In closing, how low you can go depends on how well you prepare and how much you know.

Scott Benfield is a consultant for distribution. He is the author of four books and numerous articles on marketing and sales management. His website is at www.benfieldconsulting.com and he can be reached at (630)-429-9311.

1 See McKinsey Global Survey of Business Executives, November 2004.
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2 See [Pricing Management for Distributors](#), page 51, at nawpubs.org. Benfield and Baynard, LNC Press.
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3 See Benfield Consulting white paper, " Productivity and Profit Issues in Durable Goods Distribution," BenfieldConsulting.com, January 2005.
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4 See work by Tim Underhill, or Brent Grover, at nawpubs.org, for their respective works on value negotiating or customer profitability analysis.
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5 Marginal cost to serve is defined as the minimum market cost of service for the marginal or incremental order.
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